Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
FOURTH QUARTER 2009

In This Issue:

- **Economic Backdrop – Growth Clearly Positive**
- **Equity Markets – Risk Appetite Increased**
- **Fixed Income Markets – Monetary Policy Watch**

- The monetary and fiscal stimuli introduced by the central powers around the globe to deal with the economic crisis have clearly worked, but now the side effects need to be addressed.
- Globally, economic growth although somewhat muted, has returned with many notable countries showing positive GDP growth for the 3rd quarter and into the 4th quarter, reducing the likelihood of a double-dip recession.
- Although weakened, the banking system has survived the crisis to the point that most banks are attempting to extricate themselves from any government support that was accepted during the all-too-familiar mortgaged-back calamity.
- Expectations for subpar growth are supported by the concern over job losses and the time it will take to whittle down unemployment.
- Still dealing with the hangover of indebtedness, the consumer remains key to a recovery that does not falter. Recent indicators suggest that time has healed many of the ills, which may allow governments to rein in spending as the consumer shows signs of life. To aid the consumer, banks will have to loosen the current tight credit standards.
- The developing BRIC (Brazil, Russia, India, China) and other emerging economies have been cornerstones to global growth and the economic recovery, led by China in particular.
- The equity markets' positive move in 2009 is supported by macro and micro fundamentals that suggest there is opportunity for continued gains in 2010, although not at the levels witnessed during 2009.
- Fixed income markets are focused on the potential for the Central Banks to change their monetary policy commitment from the current low interest rate strategy. Inflation is also being watched carefully as the economy continues to heal.

Economic Backdrop – Growth Clearly Positive

Heading into the New Year, global economic growth remains muted but clearly positive. Third quarter growth in the U.S. was revised to 2.8% (annual rate) from the initial estimate of 3.5% while Asia reported positive growth as well, led by China with an annualized GDP of close to 10%. Meanwhile the Euro-zone reported a marginally positive growth rate of 0.4% which was just slightly ahead of Canada's meager 0.1% GDP showing. The only notable negative around the globe was the U.K. which remained mired in negative ground at a -0.3% annual rate due in part to the financial base of its economy. The U.K., Europe and the Western economies continue to be dogged by similar core problems: high unemployment, a weakened banking system and over indebted consumers.

Many issues are most clearly illustrated in the United States. From the peak of U.S. employment in December 2007 some 8 million jobs have been lost, increasing unemployment to over 10%. More distressing is the longer term trend with respect to the recovery of these jobs. In the 1970's it took less than a year to regain the lost jobs after a recession. That gap has widened to 23 months in the 90's and 39 months following the dot com collapse. This leads many forecasters to expect a long drawn out jobless recovery from this recession, taking several years to regain the jobs lost.

Globally, consumers are struggling to repair their personal balance sheets. Savings rates remain historically high, and consumer credit is declining, but at a slowing rate. In the U.S., having declined by $8.8 billion in September, consumer credit fell by an additional $3.5 billion in October. This is partly due to a conscious effort by the consumer to reduce their indebtedness, and partly a result of the significantly tighter credit environment, as banks restrict the availability of credit. Recently, anecdotal evidence suggests that consumer spending over the holiday season accounted for a shift from credit reduction to spending. Retail sales started to rise again with November advance retail sales growing at a 1.3% rate and December same-store sales advancing 2.8% year-over-year.

Home sales are recovering, despite the relentless rise in foreclosures. Housing starts and new home permits are creeping up, and the inventory of unsold single family homes is slowly returning to more normal levels. According to the Case/Schiller Home Price Index, home prices in America have stabilized. The housing crisis that triggered the financial crisis and the global recession is fading. The damage has been passed on to financial markets and lenders around the globe.

The Western economies have turned the corner, but remain vulnerable to rising costs and regulation as they rebuild. There is a serious risk that with the government's efforts to withdraw stimulus while consumer spending accelerates, nascent growth in these economies may be stymied. It is easy to make a list of the challenges; however global GDP seems to be finding growth support from the emerging and BRIC countries, substantially decreasing the probability of a double-dip recession. In particular, China is on track to surprise to the upside in both economic growth and potentially inflation. Ironically, China is fuelling a housing expansion in its urban areas that echoes the North American experience, but the monetary authorities also appear aware of the risks and are ready to act.

As the economy recovers, all eyes are on inflation. Currently, inflation remains tame. The economic stimulus offered by the growth in money supply has succeeded. However, the lack of appetite for spending by consumers and corporations has helped to subdue inflation. As well, manufacturing capacity utilization levels are well below levels historically associated with inflationary pressures, suggesting a fertile environment for investing as the return to economic and top line growth for companies continues.

Equity Markets – Risk Appetite Increased

The year 2009 may become known as the "year of the bounce" for equity markets around the globe. After the second worst year on record for equity markets in 2008, the markets staged a strong comeback in 2009, rallying from the bottom in March through to the end of the year. Canada, as represented by the S&P/TSX composite was up 35.05% for the year, leading many of the G7 nations. Global markets also reported very positive returns as displayed by the MSCI composite which was up 30.59%. Interestingly, in Canadian dollar terms, the MSCI was up 12.18% reflecting the strong move in the Canadian dollar throughout the year and one of the thorns that is hampering economic recovery in the Canadian economy.

Today, the question remains, was it just a bounce or is the strength in the equity markets justified and more importantly, sustainable for 2010? Certainly some of the upward move in 2009 has been what some may call a relief rally. The markets initially anticipated a far poorer investing environment (housing crisis, financial system collapse and recession to mention a few) than actually occurred and therefore the selloff was overdone resulting in a rebound. However, much of the upward move would seem to be based on fundamentals both macro and micro in nature.

On the macro scale, the financial system has healed quickly moving from the concern of a collapse to the point where banks are quickly trying to exit any government bailout support they obtained. Time has helped to start the healing in the US housing market. Since the peak in June of 2005 and subsequent sell off, the US housing market has shown steady improvement in 2009 with inventory declines, price stabilization and new home sales improving. Meanwhile, economic numbers, as discussed previously, show continual improvement on a global basis as the bottom seems to have passed and the recovery gains momentum.

On the micro scale, companies have surprised investors with their resilience and bottom line growth. Companies adjusted costs quickly to the macro environment through employee declines, inventory reductions and productivity improvements that drove margin stabilization and bottom line numbers that exceeded depressed expectations. The watch word for 2010 will be "growth", or more specifically, "revenue growth". If consumer confidence continues to increase, this will spur consumer spending and allow governments to withdraw support. With the consumer being 70% of GDP, this should result in top line or revenue growth for companies. Companies have become both operationally and financially efficient in this environment and consequently any increase in revenue will drop directly to the bottom line offering further support to the equity markets which suggests sustainability and an increased appetite for risk. This does not suggest that we anticipate returns to be as robust in 2010 as they were in 2009. The market has already discounted much of the healing and the economy will now have to thrive on a consumer whose confidence has been shaken.

Preparing for an environment of low growth in which capital may be scarce due to tight credit conditions and potentially increasing taxes, our investment thesis reflects companies that are self sustaining from a growth and financial point of view with valuations that do not reflect their potential. Companies such as Apple Inc. and Canadian National Railway are two recent additions that display this general thesis in our client's portfolios. Both of these companies have managed through the down cycle very well and are now poised to benefit from any economic improvement that may be sustained. Although each company operates in very different industries, they have both displayed strong leadership qualities in their respective field which is a testament to the depth of management. Meanwhile, we have been able to purchase these securities at levels that incorporate great long term value giving some protection to any unanticipated market turbulence.

Fixed Income Markets – Monetary Policy Watch

The fixed income market has continued to provide good opportunity in the fourth quarter, but there is a growing sense of vulnerability. Corporate credit spreads have remained on the tightening trend, approaching pre-crisis "normal" levels.

The yield curve remains stubbornly steep. The near record level spread between the short and long end of the curve is due in large part to the Central Banks' commitment to maintain short rates at or near zero. A quote from Mr. Bernanke puts the Central Bank strategy in focus: "*exceptionally low levels of the Federal Funds rate for an extended period*". This strategy not only keeps the short end of the curve low but also increases the vulnerability of the government bond market to any change in sentiment on the part of monetary authorities. In the meantime, the bond market has a seemingly bottomless appetite for new issues of debt, both government and corporate. For example, in the final days of 2009, a traditionally quiet time, the US Treasury was able to successfully issue $118 billion in new bonds, and is expected to raise roughly $2.4 trillion in 2010.

In Canada, the Federal Government, Provinces and Municipalities have been able to borrow all the funding they have needed, and benefited from tighter spreads while doing it! This has been even more strongly illustrated in the corporate bond market. In the first three quarters of 2009, issuers needed to price in a concession (or excess yield) to encourage buyers. By the fourth quarter the concession had largely retreated to pre-crisis levels, but buyers have continued their pursuit of new issues. On the other hand, new issue volumes have not been sufficient to meet investor demand resulting in disappointing allocations. This lack of availability of new issue paper has maintained a subdued secondary market as investors do not wish to sell unless they can replace the holding.

With the strong new issue demand, it is hard to see a serious concern, but it is there. The bond market is vulnerable to shifts in sentiment on interest rates and inflation. Administered interest rates seem to be too low, and cannot remain there for much longer. Central Banks will need to respond to economic growth, even while they grapple with the need to begin to withdraw the immense amount of liquidity that was poured into the world economies to prevent collapse. That in turn requires higher interest rates. While the actual magnitude of interest rates required may not be great, the simple act of transition to raising rates will have a strong negative effect on the market.

Along with economic improvement comes an inflation concern. We remain vigilant to act on any inflationary signs with the possible implementation of real return bonds across clients portfolios. In the meantime, we have focused on the corporate market, and have greatly reduced our direct exposure to the government bond market, when permitted to do so by the client account objectives and constraints. Economic growth will be good for the corporate market, allowing us to conserve capital and take advantage of any pricing inefficiencies.

Barrantagh Investment Management Inc. provides disciplined portfolio management to institutional and individual investors. The firm is committed to a high level of client service provided directly by its experienced partners. We are dedicated to preserving our clients' capital while generating growth through consistent application of our value-based fundamental investment philosophy. We manage portfolios on a segregated basis to meet our clients' investment objectives. Because the firm is owned by our professional staff we maintain a completely independent and objective perspective.

For more information contact:
Barrantagh Investment Management Inc.
(416) 868-6295
Copyright 2009 Barrantagh Investment Management Inc. All rights reserved. Reproduction of portions of this Commentary is permitted provided the source is noted. Please notify us at info@barrantagh.com of any reproductions.